RETIREMENT PLANNING

Markets Got You Down? Consider a Roth Conversion

By Brian W. Kelly, MoneyLetter Publisher

Nobody wants to pay taxes now when you can defer them to a future year, right?

Not so fast. Are there times when it makes sense to take taxable income that you don't need for current expenses? One of MoneyLetter's colleagues, Bruce Hardy – portfolio manager for the MoneyLetter Managed Account Program (MMAP) – had a recent conversation with a client where the action plan was to do just that … convert some of the client's Traditional IRA assets to a Roth IRA. Remember, any withdrawal from a traditional IRA is taxed as ordinary income, but withdrawals from a Roth are tax-free if the account has been open for five years.

The trigger for the discussion was price declines over the course of 2022. Instead of lamenting this year's negative returns, the client took an opportunistic view. To illustrate, let's look at an example: Assume Retiree A held 10 shares of Traditional IRA Fund A, and at the end of 2021 the position was worth $100,000. If, due to market performance that value has fallen to $75,000, the retiree would be able to convert all 10 shares from Traditional to Roth with a tax bite that's reduced by 25%, due to the price decline.

Whether you think tax rates will be lower or higher when you're retired (we think they'll be higher for most subscribers), a Roth IRA conversion may make sense for you. If you have an unshakable conviction that your tax bill will be lower in retirement, your decision is easier—in favor of the Traditional IRA—but it's still no layup. First, you could be wrong. Even if you're right, your tax savings may not outweigh the other advantages of the Roth.

Let it grow: No withdrawals required, ever

Both Traditional and Roth IRAs allow your savings to grow tax-free, and the earnings on those earnings, over time, are the engine of your account's potential growth. But a Traditional IRA has strict rules and stiff penalties related to when you must begin taking withdrawals during your lifetime. Required Minimum Distributions (RMDs) begin at age 72, but for a Roth IRA there are no such requirements. (Update: The SECURE 2.0 Act of 2022, which was signed by President Biden on December 29, aims to make it easier for Americans to save for retirement by, among other things, raising the RMD age to 73 on January 1, 2023, and then to 75 on January 1, 2033.) All Roth savings can continue growing tax-free over your lifetime. (Both Traditional and Roth IRAs allow you to continue to contribute after retirement if you have earned income.)

The client, now 65 years old, found herself in the 12% federal tax bracket which has a ceiling close to $84,000 (Married Filing Jointly).. Her social security and other earnings are about $40,000, so that left an opening of about $44,000 before she hit the next tax bracket. The client decided to convert approximately $44,000 from her Traditional IRA to her Roth IRA, thereby avoiding (potentially) future higher tax rates and lowering her RMDs starting in a few years.

Note: Many retirees are choosing to wait on collecting Social Security to age 70, which potentially opens a larger window for converting Traditional IRA assets to a Roth without jumping tax brackets.

Contribute some—Convert a lot

If you decide a Roth IRA is right for you, you can contribute up to the maximum each year, and you can also convert all or part of your Traditional IRA to a Roth account, regardless of your income, with no annual limit.

The rub: You'll pay tax on the conversion amount in the year you make it. Generally, the further you are from retirement, the more likely you are to recoup the value of the tax paid at conversion. But the calculation can be complex. We can help you work out a break-even point.

Lighten the tax burden on your heirs

Any non-spouse beneficiaries who inherit your Roth IRA may have to take RMDs, with some exceptions, but not for 10 years, and they won't have to pay any federal income tax on their withdrawals if the account's been open for at least five years. That allows Roth owners to pass potentially significant assets to their heirs essentially tax-free.

Gain flexibility for the unforeseen

Roth IRAs allow withdrawals of contributions at any time without penalty. That makes them a good source for emergency cash needs. However, because the withdrawals of earnings before age 59½ are treated as taxable income, try to avoid early withdrawals as you may wind up with a tax emergency on top of the initial crisis. Explore other options first. There are a number of tax and investment planning strategies that can be used to offset some or all of the ordinary income tax that is trigger in the year of an IRAto-Roth conversion, which have been referenced in this column in the past. Some may include additional investment in vehicles that create offsetting ordinary income tax deductions, such as oil and gas, or depreciation and tax credits for material participation in investments such as solar. These may require accredited investor status, so consult with a financial professional who is familiar with these investments.

FAQs:

What are the contribution limits?

For the 2022 tax year, for either type of IRA: If you're under 50, up to $6,000. If you're age 50 or older, up to $7,000. For the 2023 tax year, the limits go up to $6,500/$7,500.

What is the deadline for making contributions in a given year?

For either type of IRA, the deadline is typically April 15th.

Will I have to take RMDs?

For a Roth IRA, no. For Traditional IRA, yes by April 1 of the year following the year you reach age 73.

Is there a 10% penalty for withdrawals taken before age 59½?

For Roth IRA, only for withdrawals of earnings, but not for contributions. For Tradition IRA, yes on both contributions and earnings.

If you need assistance with your retirement investing strategies, reach out to Bruce Hardy at Asset Strategy Advisors, 781-235-4426 ext. 122, or bwh@assetstrategy.com